85-1628

Supreme Court, U.S.
FILED
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No. _____

IN THE

Supreme Court of the United States

OCTOBER TERM, 1985

THE ESTATE OF NELLIE S. JOHNSTON, Deceased, by ROBERT B. PAYNE, Independent Executor,

Petitioner,

v.

UNITED STATES OF AMERICA,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

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QUESTION PRESENTED

Whether the Federal Estate Tax can be legally assessed on income generated by a decedent's oil and gas properties after a decedent's death under 26 U.S.C. §2001(a) when the executor elects pursuant to 26 U.S.C. §2032(a) to value the decedent's gross estate as of the date six months after the decedent's death.

LIST OF PARTIES

The parties listed in the caption hereof are all the parties to the proceeding sought to be reviewed.

TABLE OF CONTENTS

Question Presented i
List of Parties ii
Table of Contents iii
Table of Authorities iv
Opinions and Judgments Below v
Statement of Jurisdiction vi
Statutory Provisions Involved vii
Statement of the Case 1
Reasons Relied On for the Allowance of the Writ of Certiorari 3
A. The Fifth Circuit Has Decided an Important Question of Federal Law Which Has Not Been, But Should Be, Settled by This Court 3
B. The Fifth Circuit Has Decided a Federal Question In a Way Which Conflicts With Applicable Decisions of This Court 4
Conclusion 9
Appendix A
Appendix B
Appendix C

TABLE OF AUTHORITIES

Cases

Anderson V. Helvering, 310 U.S. 404(1940) 4, 5, 6
Bull v. United States, 295 U.S. 247(1935) 4, 6, 7, 8
Maass v. Higgins, 312 U.S. 443(1941) 3, 4, 5

Statutes

26 U.S.C. § 2001(a) ..... i, vii
26 U.S.C. § 2031(a) vii
26 U.S.C. § 2032(a) ..... i, vii, 1, 2, 4
26 U.S.C. § 2051 vii
28 U.S.C. § 1254(1) vi
28 U.S.C. § 1346(a)(1) 2

OPINIONS AND JUDGMENTS BELOW

Attached hereto as Appendix A is a true and correct copy of the Opinion of the United States Court of Appeals for the Fifth Circuit, dated January 8, 1986.

Attached hereto as Appendix B is a true and correct copy of the Final Judgment of the United States District Court for the Northern District of Texas, Dallas Division, dated July 2, 1984.

Attached hereto as Appendix C is a true and correct copy of the Memorandum Order of the United States District Court for the Northern District of Texas, Dallas Division, dated April 27, 1984.

STATEMENT OF JURISDICTION

The United States District Court for the Northern District of Texas, Dallas Division, entered summary judgment in favor of the Petitioner on April 27, 1984. The United States Court of Appeals for the Fifth Circuit reversed and remanded the judgment of the District Court on January 8, 1986. This petition for writ of certiorari is filed within ninety (90) days after the entry of the Fifth Circuit's judgment. This Court's jurisdiction is invoked under 28 U.S.C §1254(1).

STATUTORY PROVISIONS INVOLVED

26 U.S.C. §2001(a) provides:

(a) Imposition. A tax is hereby imposed on the transfer of the taxable estate of every decedent who is a citizen or resident of the United States.

26 U.S.C. §2031(a) provides:

(a) General. The value of the gross estate of the decedent shall be determined by including to the extent provided for in this part, the value at the time of his death of all property, real or personal, tangible or intangible, wherever situated.

26 U.S.C. §2032(a) provides:

(a) General. The value of the gross estate may be determined, if the executor so elects, by valuing all the property included in the gross estate as follows:

(1) In the case of property distributed, sold, exchanged, or otherwise disposed of, within 6 months after the decedent's death such property shall be valued as of the date of distribution, sale, exchange, or other disposition.

(2) In the case of property not distributed, sold, exchanged, or otherwise disposed of, within 6 months after the decedent's death such property shall be valued as of the date 6 months after the decedent's death.

(3) Any interest or estate which is affected by mere lapse of time shall be included at its value as of the time of death (instead of the later date) with adjustment for any difference in its value as of the later date not due to mere lapse of time.

26 U.S.C. §2051 provides:

For purposes of the tax imposed by section 2001, the value of the taxable estate shall be determined by deducting from the value of the gross estate the exemption and deductions provided for in this part.

No._____

In The

Supreme Court of the United States

October Term, 1985

The Estate of Nellie S. Johnston, Deceased, by Robert B. Payne, Independent Executor,

Petitioner,

v.

United States of America,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

STATEMENT OF THE CASE

Nellie S. Johnston (the "Decedent") died on January 27, 1974 (the "Date of Death"), a resident of the State of Texas. The Decedent's will appointed Robert B. Payne ("Payne") as the Independent Executor. The Decedent's will was duly admitted to probate on February 11, 1974 and Payne was confirmed as Independent Executor. Payne continues to serve as Independent Executor of the Decedent's estate (the "Estate").

The Independent Executor elected pursuant to 26 U.S.C. § 2032(a) to value the Decedent's gross estate as of the date six months after her death, to wit July 27, 1974 (the "Alternate Valuation Date") rather than the Date of Death. During her

lifetime and upon the Date of Death, the Decedent owned royalty interests and working interests in oil and gas properties located primarily in the State of Texas.

During the period between the Date of Death and the Alternate Valuation Date (the "Alternate Valuation Period") the Decedent's royalty interests and working interests continued to produce income ("Interim Production Income") and the Independent Executor duly reported the Interim Production Income for federal income tax purposes and paid the proper federal income tax thereon. The amount of the Interim Production Income is $156,011. The Independent Executor did not, however, include any of the Interim Production Income in the Decedent's gross estate for federal estate tax purposes.

Upon audit of the Decedent's estate tax return, the Internal Revenue Service (the "IRS") included the Interim Production Income in the Decedent's gross estate and assessed an estate tax thereon. This increase in the gross estate, together with other adjustments no longer in dispute, resulted in a net deficiency of federal estate taxes in the amount of $278,941.59 which was paid, with interest, by the Estate.

On April 11, 1979, the Estate filed a claim for refund of estate taxes in the amount of $402,097, plus interest, claiming, among other things, that the inclusion of the Interim Production Income in the Decedent's gross estate was erroneous. The IRS denied the claim for refund on May 15, 1979.

On October 11, 1979 the Estate filed suit against the United States (the "Government") in the United States District Court for the Northern District of Texas, Dallas Division, alleging, among other things, that the inclusion of the Interim Production Income in the Decedent's gross estate was an unwarranted extension of 26 U.S.C. §2032(a). The jurisdiction of the District Court was proper under 28 U.S.C. §1346(a)(1). All issues in the case were settled except for the issue presented to this Court which was decided by the District Court in favor of the

Estate. The District Court held pursuant to Memorandum Order filed April 27, 1984 that the Interim Production Income constituted income, and not principal, and was therefore not subject to the federal estate tax. See Appendix C, page 14.

The Government appealed the District Court decision to the United States Court of Appeals for the Fifth Circuit (the "Fifth Circuit"). The Fifth Circuit reversed and remanded the decision of the District Court without even addressing the rationale upon which the District Court opinion was based i.e., oil and gas production is treated as income, and not principal. Instead, the Fifth Circuit held that the Interim Production Income represents both estate assets and income and may be taxed as both. See Appendix A, page 10. The Fifth Circuit held that the portion of the value of the Interim Production Income which is subject to the estate tax is the in-place value of the oil and gas on the date(s) of its severance. See Appendix A, page 11. The case was remanded to the District Court to determine the in-place value.

REASONS RELIED ON FOR THE ALLOWANCE OF WRIT OF CERTIORARI

A. THE FIFTH CIRCUIT HAS DECIDED AN IMPORTANT QUESTION OF FEDERAL LAW WHICH HAS NOT BEEN, BUT SHOULD BE, SETTLED BY THIS COURT

The precise question presented to this Court is one of first impression. However, this Court in the case of *Maass v. Higgins,* 312 U.S. 443 (1941) decided the "sister" question of whether the federal estate tax could be legally assessed on other types of income such as rents, dividends and interest received by an estate during the alternate valuation period when an estate elects to value the gross estate on the alternate valuation date. The Supreme Court held that the federal estate

tax could not be legally assessed on those types of income. See 312 U.S. 443 at 447.

Now, the question of whether the federal estate tax can be legally assessed on another type of income, oil and gas income, has been decided by the Fifth Circuit in this case in a manner which is in conflict with the *Maass* decision. The Petitioner contends that this Court is the proper forum to decide this question and extend the principal of the *Maass* case to oil and gas income. This Court recognized the importance of this question in *Maass* and therefore granted certiorari. See 312 U.S. 443 at 445. Petitioner is asking this Court to again recognize the continued importance of this question and grant certiorari herein.

Further, the Petitioner respectfully requests this Court to take notice of the fact of declining prices of domestic oil and gas and the impact thereof on the present day estates of decedents who would be inclined to elect alternate valuation treatment under 26 U.S.C. §2032(a). The opinion of the Fifth Circuit presents an undue hindrance on the practical ability of present day estates to elect alternate valuation treatment. For this reason the Court should grant certiorari herein and decide the question presented.

B. THE FIFTH CIRCUIT HAS DECIDED A FEDERAL QUESTION IN A WAY WHICH CONFLICTS WITH APPLICABLE DECISIONS OF THIS COURT

The decision of the Fifth Circuit in this case conflicts with this Court's decisions in *Maass v. Higgins*, 312 U.S. 443 (1941), *Anderson v. Helvering*, 310 U.S. 404 (1940) and *Bull v. United States*, 295 U.S. 247 (1935).

Conflict with Maass v. Higgins. In the *Maass* decision this Court was asked to pass on the validity of the treasury regulation promulgated under 26 U.S.C. 811(j) (predecessor statute to 26 U.S.C. §2032(a)) which regulation required that

if the executor elected alternate valuation treatment, then the executor must return, as a part of the gross estate, that portion of rents, *royalties,* interest and dividends received during the alternate valuation period which had not accrued prior to death (emphasis added). See 312 U.S. 443 at 446. This Court held that the just described treasury regulation was an unwarranted extension of the plain meaning of the statute under which it was promulgated and could not be sustained. See 312 U.S. 443 at 447. The Petitioner certainly does not suggest to this Court that royalty income was involved in the facts before this Court in *Maass;* however, the Petitioner does contend that this Court's striking down the above described treasury regulation casts a significant doubt on the correctness of the Fifth Circuit's opinion in this case in holding that oil and gas royalties are includable in the gross estate.

Furthermore, this Court stated in *Maass* that if rents, interest and dividends are collected by a decedent's estate, the executors are bound to return them and pay tax upon them as income and that such receipts are never treated as on account of principal. See 312 U.S. 443 at 447. The Petitioner contends that those statements are not insignificant statements and set forth legal principles which should be given application in the context of the question now presented to this Court. Thus, the Interim Production Income was collected by the Independent Executor who was bound to return it and pay a tax upon it as income; and that the Interim Production Income is never treated as on account of principal. Under the federal tax laws there is no fundamental distinction drawn between oil and gas income, on the one hand, and rents, dividends and interest, on the other. Yet, in violation of the *Maass* case and federal tax laws, the Fifth Circuit has drawn a very fundamental distinction.

Conflict with Anderson v. Helvering. This Court in *Anderson v. Helvering,* 310 U.S. 404 (1940) clearly recognized that the

production of oil and gas is treated as an income-producing operation and not as a conversion of capital investment as upon a sale. See 310 U.S. 404 at 407. This Court also recognized in *Anderson* that gross income from an oil and gas property means gross income received from the operation of an oil and gas property by one who has a capital investment therein, not income from the sale of the oil and gas property itself. See 310 U.S. 404 at 408-09.

The Fifth Circuit opinion fails to recognize the fundamental distinction recognized by this Court in *Anderson* between (i) gross income received from the operation of an oil and gas property and (ii) income received from the sale of the oil and gas property itself. In this regard please note the Fifth Circuit accepted the Government's position that the Decedent died owning "X amount of in-place oil and gas reserves" and rejected the Estate's position that the Decedent died owning the oil and gas properties themselves. See Appendix A, page 8.

Further, the example used by the Fifth Circuit in its opinion to illustrate the Estate's position on this basic principle is erroneous. The Fifth Circuit stated that under the Estate's position if one died possessed of $10,000,000 in oil and gas reserves and produced the entirety during the alternate valuation period, then there would be no federal estate tax. See Appendix A, page 9. First, one does not die possessed of oil and gas reserves, rather one dies possessed of the oil and gas properties themselves. Second, in the real world, no oil and gas reserves would, or could, be produced even to a fraction of the extent suggested in the Fifth Circuit's example. There are regulatory restrictions, operating agreements, well and reservoir capacities, reservoir damage, market conditions and numerous other factors that would prevent anybody from fully producing all of their oil and gas properties during the alternate valuation period just to circumvent the federal estate tax.

However, the "principle" drawn from this example is the foundation upon which the Fifth Circuit decision is based.

Conflict with Bull v. United States. This Court in the case of *Bull v. United States,* 295 U.S. 247 (1935) set forth the principle of law that a receipt cannot be both corpus and income at the same time for purposes of federal estate and federal income taxation. See 295 U.S. 247 at 258. Under the facts of the *Bull* case, the decedent was a partner in a partnership at the time of his death. Under the partnership agreement, the decedent's estate was entitled to receive the profits the decedent would have received for the remainder of the partnership's fiscal year had he remained alive. Up to the date of his death the decedent's share of the accumulated profits of the partnership was $24,124.20. From the time of the decedent's death and through the remainder of the partnership's fiscal year the decedent's estate realized $212,718.79 in profits. The executor included the $24,124.20 ("pre-death profits") in the gross estate but did not include the $212,718.79 ("post-death profits"). Upon audit, the Commissioner included the post death profits in the gross estate and assessed an estate tax thereon. Subsequent to the estate tax audit, the Commissioner assessed an income tax on the post-death profits. The estate argued before this Court that it had paid a double tax on the post-death profits. See 295 U.S. 247 at 251-52.

This Court held that the *pre-death profits* were income to the decedent and taxable to him as such; and that the *pre-death profits* were also corpus of his estate and subject to the estate tax. See 295 U.S. 247 at 254. However, this Court further held that the *post-death* profits were not corpus to be taxed in the decedent's estate, but rather income upon which an income tax was due. See 295 U.S. 247 at 254.

As applied to this case, the Petitioner clearly concedes (i) that the Decedent's oil and gas income which had accrued prior to her death was properly subject to an income tax and (ii) to

the extent that such income was held at the date of the Decedent's death it was properly subject to the estate tax. In this situation, there are clearly two separate instances of taxation. This is the "double taxation" permitted by this Court in *Bull*. Contrariwise, the Fifth Circuit states that this form of "double taxation" applies to the facts of the instant case. See Appendix A, page 10.

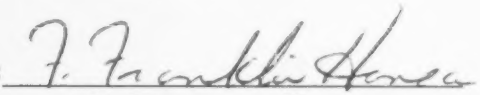
The Fifth Circuit has obviously confused this concept of "double taxation" between pre-death income and post-death income. The Estate paid both an income tax and an estate tax on the same receipt of the Interim Production Income. The receipt of the Interim Production Income by the Estate was the sole basis of two separate and distinct tax assessments. The Interim Production Income is in the same position in this case as the post-death profits in the *Bull* case. This Court held in *Bull* that the post-death profits were not subject to the estate tax because those profits would not have been capital to the decedent. See 295 U.S. 247 at 256. Likewise, had the Decedent in this case lived, the receipt of what would have been the Interim Production Income would not have been capital to her. Notwithstanding, the Fifth Circuit held, citing *Bull*, that the Interim Production Income was both estate assets and income and may be taxed as both. See Appendix A, page 10. The Fifth Circuit decision requires that the Interim Production Income be treated as corpus for estate tax purposes and as income for income tax purposes. There is no authority for this anomalous treatment. This is the double taxation the Petitioner complains of in this case and which this Court in *Bull* has held to be impermissible.

CONCLUSION

For the foregoing reasons, Petitioner hereby respectfully requests this Court to issue a Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit to review the opinion and judgment of the Fifth Circuit.

Respectfully submitted,

PAYNE & VENDIG

By: 

F. FRANKLIN HONEA
Attorneys for Petitioner

April 4, 1986

APPENDIX A

UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

THE ESTATE OF NELLIE S. JOHNSTON,
Deceased, by ROBERT B. PAYNE,
Independent Executor,
Plaintiff-Appellee,

v.

UNITED STATES OF AMERICA,
Defendant-Appellant.

No. 84-1757

OPINION

Filed January 8, 1986

Before: Charles Clark, Chief Judge, Henry A. Politz, and Edith H. Jones, Circuit Judges.

Opinion by Judge Henry A. Politz

Appeal from the United States District Court
for the Northern District of Texas
A. Joe Fish, District Judge, Presiding

SUMMARY

Taxation

Appeal from a district court ruling in favor of an estate. Reversed and remanded.

The executor of an estate exercised the option available under 26 U.S.C. § 2032(a) and chose to value the estate (for estate tax purposes) six months after the testator's death. The estate contained certain oil and gas properties which paid royalties generating net income in excess of $150,000 during the six months between the date of death and the date of evaluation. In calculating the estate tax due, the IRS considered the oil and gas produced during the interim period to be property disposed of, and added the royalties

to the estate's value. The district court disagreed and the IRS appealed.

[1] The issue can be characterized as whether the proceeds received after death are considered as in the estate at the time of the death, and subsequently appearing in a changed form, or whether these proceeds are income of the estate wholly severed from taxable estate assets. **[2]** *Maass v. Higgins*, 312 U.S. 443 (1941), directs a review of each case on its own facts, with an eye toward determining the common understanding whether the proceeds in question truly represent income produced by the estate, or, rather, are the translation of the corpus of the estate into another form. While rents, dividends, and the like represent an income stream separate from the principal, mineral royalties are different because while a fully depreciated building generally survives its tax-depreciation lifespan and continues to provide use, a fully depleted mine or well produces nothing but storage space. **[3]** The government's position that the estate was depleted by the removal of oil and gas during the six-month period comports with common understanding. **[4]** The estate's argument that acceptance of the government's position would defeat the legislative purpose behind section 2032 fails because the alternative valuation date was not designed to permit an estate to reduce its liability by disposing of assets. **[5]** The appropriate value to be assigned to oil and gas produced during the interim period is the in-place value of that oil and gas on the date of its severance.

OPINION

HENRY A. POLITZ, Circuit Judge:

This case presents the *res nova* question whether proceeds from interests in oil and gas properties, received by a decedent's estate between the date of death and the alternate valuation date authorized by 26 U.S.C. § 2032(a), are includible in the gross estate, in whole or in part, for the purpose of determining the federal estate tax.[1] The district court held that no portion of such proceeds was

[1]We have considered the valuation issue, *Estate of Frankel v. United States*, 512 F.2d 1007 (5th Cir. 1975), but not the question of inclusion of any portion of the proceeds into the gross estate.

includible in the gross estate. 586 F. Supp. 500 (N.D. Tex. 1984). The government appeals. We reverse and remand.

BACKGROUND

The facts are not in dispute and need only be summarized since this appeal presents solely a question of law.

Nellie S. Johnston died testate on January 27, 1974. Her will named Robert B. Payne as executor. Payne exercised the option authorized by 26 U.S.C. § 2032(a)[2] and chose to value Johnston's estate as of six months after her death rather than on the date of her death. Johnston died owning various working and royalty interests in numerous oil and gas properties, most of which were located in Texas. In the six months after her death her interests generated net income of $156,011 on which the estate paid income tax after deducting the statutory allowance for depletion. 26 U.S.C. § 611. Following an audit by the Internal Revenue Service, this entire income was included in Johnston's gross estate[3] under 26 U.S.C.

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[2]26 U.S.C. § 2032(a) provides in pertinent part:

> (a) General. The value of the gross estate may be determined, if the executor so elects, by valuing all the property included in the gross estate as follows:
>
> > (1) In the case of property distributed, sold, exchanged, or otherwise disposed of, within 6 months after the decedent's death such property shall be valued as of the date of distribution, sale, exchange, or other disposition.
> >
> > (2) In the case of property not distributed, sold, exchanged, or otherwise disposed of, within 6 months after the decedent's death such property shall be valued as of the date 6 months after the decedent's death. . . .

[3]The gross estate is defined by 26 U.S.C. § 2031(a):

> The value of the gross estate of the decedent shall be determined by including . . . the value at the time of death [subject to the alternate valuation date] of all property, real or personal, tangible or intangible, wherever situated.

See 26 U.S.C. §§ 2033-2044.

§ 2032(a)(1), and a net deficiency of $278,941.59 in estate taxes was assessed.[4]

The IRS made its determination pursuant to 26 CFR § 20.2032-1(d)[5] and Rev. Rul. 71-317, 1971-72 Cum. Bull. 328, issued thereunder, in which the IRS opined that "the value of the royalty interest [in mineral-producing properties] in the gross estate at the alternate valuation date is the sum total of the in-place fair market value of the reserves . . . in existence [six months] after the date of death plus the value of the included property disposed of during the interim period." The IRS also declared that "[t]he value of the included property is determined by applying an appropriate discount factor to the net proceeds (net income) from mineral production during the interim period." Rev. Rul. 71-317, 1971-72 Cum. Bull. 328, *reprinted in* 38 Oil & Gas Rptr. 711.

After paying the deficiency, the executor filed a claim for refund, which was denied. This action followed. After all other claims were settled, both parties moved for summary judgment since no genuine issue of fact existed and the motion presented only a question of law. The district court granted the motion of the estate.

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[4]The bulk of the deficiency was attributed to an alleged undervaluing of the estate's oil and gas interests, not to the exclusion of the subject income. The dispute over the valuation of these assets was part of this suit but was settled. *See* 586 F. Supp. at 501. The only issue remaining is the question of the includibility of the income received during the six months post-death.

[5]26 CFR § 20.2032-1(d) reads in pertinent part:

> "*Included property" and "excluded property.*" If the executor elects the alternative valuation method under section [2032], all property interests existing at the date of decedent's death which form a part of his gross estate as determined under sections 2033 through 2044 are valued in accordance with the provisions of this section. Such property interests are referred to in this section as "included property." Furthermore, such property interests remain "included property" for the purpose of valuing the gross estate under the alternate valuation method even though they change in form during the alternate valuation period by being actually . . . disposed of, in whole or in part, by the estate. On the other hand, property earned or accrued (whether received or not) after the date of the decedent's death and during the alternate valuation period with respect to any property interest existing at the date of the decedent's death, which does not represent a form of "included property" itself or the receipt of "included property" is excluded in valuing the gross estate under the alternate valuation method . . . .

ANALYSIS

At the threshold we note that the district court correctly concluded that federal law was applicable to this dispute. 586 F. Supp. at 503. State law is relevant to the determination of the existence of legal and equitable interests, but federal law governs "when and how [these interests] shall be taxed." *Burnet v. Harmel*, 287 U.S. 103, 110, 53 S.Ct. 74, 77, 77 L.Ed. 199, 205 (1932); *Carr Staley, Inc. v. United States*, 496 F.2d 1366, *reh'g denied*, 502 F.2d 1167 (5th Cir. 1974), *cert. denied*, 420 U.S. 963, 95 S.Ct. 1355, 43 L.Ed.2d 441 (1975); *see also Gilchrist's Estate v. C.I.R.*, 630 F.2d 340 (5th Cir. 1980).

[1] The Internal Revenue Code of 1954 imposes an excise tax on the transfer of an estate at death. The statutory scheme and regulations provide that the contents of a decedent's gross estate are fixed as of the moment of death. 26 CFR § 20.2032-1(a);[6] 26 U.S.C. §§ 2031-33; *see generally*, Bittker, *Federal Taxation of Income, Estates and Gifts* (1984) ¶ 132.7.2. The variable allowed relates only to the valuation of the estate; it does not affect the inventory of assets which becomes inviolate at the death of the owner. Under the statute and regulations, assets sold continue as included property "even though they change in form." The issue before us is whether the proceeds received after Nellie Johnston's death are to be considered as in her estate at the time of her death, subsequently

[6] 26 CFR § 20.2032-1(a) provides in pertinent part:

> In general, section 2032 provides for the valuation of a decedent's gross estate at a date other than the date of the decedent's death. More specifically, if an executor elects the alternate valuation method under section 2032, *the property included in the decedent's gross estate on the date of his death* is valued as of whichever of the following dates is applicable:
>
> (1) Any property distributed, sold, exchanged, or otherwise disposed of within 6 months . . . after the decedent's death is valued as of the date on which it is first distributed, sold, exchanged, or otherwise disposed of;
>
> (2) Any property not distributed, sold, exchanged, or otherwise disposed of within 6 months . . . after the decedent's death is valued as of the date 6 months . . . after the date of the decedent's death. . . . (Emphasis added.)

appearing in a changed form, or whether these proceeds are income of the estate wholly severed from taxable estate assets.

Under the government's rationale, the oil and gas payments are nothing more than a change in the form of estate assets from in-place oil and gas reserves to money. Since the in-place reserves were in the estate at Johnston's death, the payments, representing a conversion of those reserves to money, are likewise in the estate. 26 CFR § 20.2032-1(d).

The argument advanced by the estate, accepted by the district court, is based on its reading of the Supreme Court's decision in *Maass v. Higgins*, 312 U.S. 443 (1941). In *Maass* and its companion cases, the Court reviewed an IRS regulation issued under a predecessor to § 2032.[7] That regulation directed that when an estate was valued on the alternate valuation date, all rents, royalties, interest, and dividends received by the estate after the decedent's death, and not accrued prior to date of death, were to be fully included in the taxable estate. The petitioners in the *Maass* litigation challenged the inclusion in the gross estate of such rental and dividend income received between the date of the decedents' deaths and the alternate valuation dates. The Court agreed with the petitioners' arguments.

In upholding the contention of the taxpayers-petitioners in *Maass*, the Court referred to the "common understanding [that] rents, interest, and dividends are income." *Id.* at 447. The Court expressly rejected as "unreal and artificial" the theory behind the IRS regulation that for purposes of estate tax valuation the asset consisted of two elements, "one the right of ownership the other the right to receive the income." *Id.* Instead, the Court held that the value of an asset is to be determined by viewing all of its components, including the income stream, "as an entirety." 312 U.S. at 448.

The government argues that *Maass* and its progeny are inapposite, maintaining that the contents of the estate are fixed as of the moment of the decedent's demise. This point is not in dispute.

[7] *See* 26 U.S.C. § 811(j) (1935), *quoted in Maass v. Higgins*, 312 U.S. at 444 n.1.

From this linchpin the government contends that, unlike the proceeds in *Maass*, the proceeds at bar are nothing more or less than a change in the form of the asset in Johnston's estate at the time of her death, from in-place oil and gas reserves to cash. Analogies to cases involving dividend income from stock or bond investments or rentals from leased property are not applicable because those proceeds would not be in the estate on the date of decedent's death. Finally, the government urges that the existence of the oil and gas depletion allowance in the income tax code, 26 U.S.C. § 611-17, is recognition by the Congress that revenues derived from the production of oil and gas reserves are commonly understood to be different from dividends or rental income.

[2] We perceive *Maass* as directing a review of each case on its own facts, with an eye toward determining the common understanding whether the proceeds in question truly represent income produced by the estate or, rather, are the translation of the corpus of the estate into another form. The former would not be included in the estate tax inventory, the latter would. One might suggest that the result in *Maass* derives as much from intuition as logic. All investment income, from whatever source, represents to some extent a portion of the investment principal. As a matter of "common understanding," however, rents, dividends, and the like represent an income stream separate from the principal. The value of the principal is determined by viewing it as an "entirety," factoring in the income stream. *Maass*, 312 U.S. at 448; 26 CFR § 20.2032-1(d)(1). This common understanding results in large measure from the apparent perception that the principal generating the dividends and rentals is not diminished by the use which produces the income. This perception of non-wasting principal is slightly fogged.[8] The tax system recognizes wasting by providing for depreciation. The critical difference, however, is that a fully depreciated building or piece of personal property generally survives its tax-depreciation lifespan and continues to provide use or an income stream, whereas a fully depleted mine or well produces nothing but storage space. Responding to the latter, Congress directly and through the IRS established what some view as the

[8]It cannot be gainsaid that a building held for rent is "used up" in some physical sense in return for the rental payment. Regardless of the accuracy of the forecast of the economic life of a structure, at some point that life ends.

painfully complex system of depletion allowances. 26 U.S.C. §§ 611-17; 26 CFR §§ 1.611-0-1.617-4; *Commissioner v. Southwest Exploration Co.*, 350 U.S. 308 (1956); *Anderson v. Helvering*, 310 U.S. 404 (1940); *Murphy Oil Co. v. Burnet*, 287 U.S. 299 (1932); *see also Commissioner v. Engle*, ___ U.S. ___, 78 L.Ed.2d 420 (1984).

Applying the foregoing, we must determine which party's position is unreal and artificial and which comports with our common understanding. *Maass*. To do so we recast the arguments.

The government argues that when Nellie Johnston died she owned interests in X amount of in-place oil and gas reserves. That amount, fixed as of the moment of her death, is the property interest within the inventory of her estate for estate tax purposes. During the six months between the date of Johnston's death and the alternate valuation date, that estate was depleted by the removal of some of the reserves, identified as Y. On the alternate valuation date the amount of in-place reserves was X-minus-Y. The value which must be included in the federal estate tax is the fair market value of X, not the diminished value of X-minus-Y.

The executor argues that at Johnston's death her estate included various mineral interests from which the estate derived income generated by the production of oil and gas. Conceding that the contents of the estate are necessarily fixed as of the date of death, the executor contends that on the alternate valuation date the estate contained the exact interests, *i.e.*, mineral interests which generated income from the production and sale of oil and gas. The estate maintains that it had not sold any of the contents of the estate, it still owned the same fractional mineral interests; it had merely realized income from one of the estate's assets.

[3] We conclude that the estate's position is artificial and that the government's position comports with common understanding.[9]

[9]We note that Texas treats oil and gas payments as returns of principal and considers oil and gas in place as a part of the realty. *Clyde v. Hamilton*, 414 S.W.2d 434 (Tex. 1967); *Keasler v. Natural Gas Pipeline Co.*, 569 F. Supp. 1180 (E.D.Tex. 1983), *aff'd*, 741 F.2d 1380 (5th Cir. 1984). The same rule is recognized in many mineral-producing states. *Ohio Oil Co. v. Indiana*, 177 U.S. 190 (1900); *Bodcaw Lumber Co. v. Goode*, 160 Ark. 48, 254 S.W. 345 (1923);

Under the theory advanced by the estate, if one died possessed of $10,000,000 in oil and gas reserves and, during the ensuing six months, the entirety was produced so that on the alternate valuation date there were no reserves whatever, there would be no federal estate tax. We cannot give the statute or regulations that anomalous interpretation. The quantity of the reserves are determined as of the date of the decedent's death; only the value to be assigned to that quantity of reserves may be changed by market variances when severed before the alternate valuation date.

[4] The estate makes additional arguments that merit some discussion. It urges that acceptance of the government's position would defeat the legislative purpose behind § 2032. The district court accepted this argument. 586 F. Supp. at 507. We do not. The alternate valuation date was not enacted to permit an estate to reduce its tax liability by disposing of estate assets. The purpose behind § 2032 is neither elusive nor uncertain. The statute was designed to mitigate the hardship resulting when the value of a decedent's assets between the date of death and the date the estate tax became due was significantly reduced. *Maass.* The *raison d'etre* of § 2032 does not suffer by our decision today; it remains to protect estates with oil and gas interests when the value of those interests declines during the six-month grace period. In the not-too-distant past that likelihood was considered remote. Not so today, considering the volatile forces extant in the world oil and gas industry.

Southern P.R. Co. v. S.F. Sav. Union, 146 Cal. 290, 79 P. 961 (1905); *Ohio Oil Co. v. Daughetee*, 240 Ill. 361, 88 N.E. 818 (1909); *Anderson v. Beech Aircraft Corp.*, 237 Kan. 336, 699 P.2d 1023 (1985); *Gerkins v. Kentucky Salt Co.*, 100 Ky. 734, 39 S.W. 444 (1897); *Federal Land Bank of N.O. v. Mulhern*, 180 La. 627, 157 So. 370 (1934); *Attorney General v. Pere Marquette R. Co.*, 263 Mich. 431, 248 N.W. 860 (1933); *Whelan v. Johnson*, 192 Miss. 673, 6 So.2d 300 (1942); *Gas Products Co. v. Rankin*, 63 Mont. 372, 207 P. 993 (1922); *Wheelock v. Heath*, 201 Neb. 835, 272 N.W.2d 768 (1978); *Bolack v. Underwood*, 340 F.2d 816 (10th Cir. 1965) (New Mexico); *Schank v. North American Royalties, Inc.*, 201 N.W.2d 419 (N.D. 1972); *Nonamaker v. Amos*, 73 Ohio St. 163, 76 N.E. 949 (1905); *Cox v. Lasley*, 639 F.2d 1219 (Okl. 1981); *U.S. Steel Corp. v. Hoge*, 468 A.2d 1380 (Penn. 1983); *Murray v. Allard*, 100 Tenn. 100, 43 S.W. 355 (1897); *Consolidated Gas Supply Corp. v. Riley*, 247 S.E.2d 712 (W.V. 1978); *Ready v. Texaco, Inc.*, 410 P.2d 983 (Wyo. 1966).

Finally, the estate argues that the inclusion of the interim proceeds in the gross estate would result in double taxation because the estate paid income tax on the proceeds. We are not persuaded. The estate tax is due on the assets in the decedent's estate, based on the fair market value of those assets on the applicable evaluation date. If those assets produce income, as defined by the Congress, income tax is due thereon. This "double taxation" is valid.

Changing the facts in the case at bar slightly illuminates this conclusion. Had the entirety of the reserves remained in place for more than six months after Johnston's death, the estate tax would have been based on the value of the entirety of the reserves. No one would dispute that statement. Thereafter, as the oil and gas was produced the applicable income tax provisions would apply. This "double taxation" is envisioned by the tax code and is not rendered illegal by *Maass*. In *Maass* there was no basis for double taxation since the proceeds were held to be only income and not part of the taxable estate. Here the proceeds represent both estate assets and income and may be taxed as both. *Bull v. United States*, 295 U.S. 247 (1935). The *Maass* Court recognized that possibility by observing that "[i]n the appraisal of a decedent's estate, rent or interest accrued to the date of death is properly treated as a capital asset." 312 U.S. at 448. As rent or interest, the prior accruals would be subject to the income tax. As a capital asset, those accruals would be subject to the estate tax.

This leads then to the final question necessary to resolution of this appeal: What portion of the proceeds are to be included in the gross estate? Appraising oil and gas interests presents unique problems. In partial response thereto Reserve Ruling 71-317, 1971-72 Cum. Bull. 328 was issued. Therein the IRS determined that the amount to be included in the gross estate in situations such as is here presented is the amount of the proceeds minus "an appropriate discount factor."[10] We find this approach inadequate, considering the complexities of evaluating oil and gas interests, and the language of 26 U.S.C. § 2032(a)(1).

[10]No "appropriate discount factor" was subtracted in the Johnston audit. The IRS concedes error. Because of our disposition we do not consider what is an appropriate discount factor.

[5] We are persuaded, and now hold, that the appropriate value to be assigned to oil and gas produced during the interim period, for inclusion in the gross estate, is the in-place value of that oil and gas on the date of its severance. The Johnston inventory included interests in oil and gas reserves. The value for estate tax purposes is the value of those reserves in place. In accordance with § 2032(a)(1), if the alternate valuation date is chosen the estate includes the in-place value of the reserves remaining on the alternate valuation date, valued as of that date, together with the in-place value of all oil and gas produced during the intervening six months, valued as of the dates of severance. Valuation of oil and gas reserves, both as to quantity and value, albeit complex, is a matter routinely done for myriad reasons, business, finance, inheritance, divorce, contract litigation, and taxes, to name a few. It is a matter within the competence of the experts. It readily may be done here.

On the present record it is not possible to determine the in-place value of the oil and gas produced as of the dates of severance. The case must be remanded for the development of evidence reflecting those values, which are then to be included in the inventory for estate tax purposes, together with the reserves remaining on the alternate valuation date.

The judgment of the district court is REVERSED and the matter is REMANDED for further proceedings consistent herewith.

APPENDIX B

IN THE

United States District Court

FOR THE
NORTHERN DISTRICT OF TEXAS
DALLAS DIVISION

THE ESTATE OF NELLIE S. JOHNSTON,
Deceased,
by Robert B. Payne,
Independent Executor,
Plaintiff

v.

UNITED STATES OF AMERICA
Defendant

CIVIL NO.
CA3-79-1271-G

FINAL JUDGMENT

WHEREAS, on the 27th day of April, 1984, this Court granted Plaintiff's Motion for Summary Judgment and denied Defendant's Cross-Motion for Summary Judgment by Memorandum Order stating the reasons therefor and directing the parties to agree upon the correct computation of the sum in question;

WHEREAS, the parties have agreed that the correct computation of the sum in question is $504,384.69 which is represented by (i) $148,500 face value of 3.5% U.S. Treasury Bonds, dated February 14, 1958 and due February 15, 1990 (the "Bonds") and (ii) the sum of $355,884.69 in cash;

WHEREAS, the sum of $355,884.69 in cash is represented by (i) a refund of estate taxes and assessed interest paid in cash by the Estate in the amount of $137,749.72, (ii) statutory interest on $137,749.72 from November 1, 1977 to June 30, 1984 in the amount of $119,348.09 and (iii) statutory interest

on the October 31, 1977 fair market value of the Bonds from November 1, 1977 to June 30, 1984 in the amount of $98,786.88, said October 31, 1977 fair market value being 76.78% of face value of $148,500 or $114,018.29; and

WHEREAS, the parties have agreed to the correct computation as aforesaid, it is therefore;

ORDERED, ADJUDGED and DECREED that Plaintiff have and recover of and from the Defendant the total sum of $504,384.69 to be paid by the Defendant to the Plaintiff as follows: (i) $148,500 face value of 3.5% U.S. Treasury Bonds, dated February 14, 1958 and due February 15, 1990 (the "Bonds") and (ii) the cash sum of $355,884.69, plus statutory interest from and after June 30, 1984 on the June 30, 1984 fair market value of the Bonds and the cash amount of $355,884.69, until paid in accordance with law.

So, ORDERED this 2 day of July, 1984.

/s/ A. JOE FISH
United States District Judge

APPROVED AS TO FORM:

/s/ ROBERT Q. STANTON

ROBERT B. PAYNE
ROBERT Q. STANTON
Attorneys for Plaintiff

/s/ MICHAEL E. GREENE

MICHAEL E. GREENE
Attorney for Defendant

APPENDIX C

IN THE

United States District Court

FOR THE
NORTHERN DISTRICT OF TEXAS
DALLAS DIVISION

THE ESTATE OF NELLIE S. JOHNSTON,
Deceased,
by Robert B. Payne,
Independent Executor,
Plaintiff

v.

UNITED STATES OF AMERICA
Defendant

CIVIL ACTION NO.
CA 3-79-1271-G

MEMORANDUM ORDER

Question Presented

These cross-motions for summary judgment present the following question of first impression concerning the federal estate tax: When a decedent's estate is valued on the alternate valuation date (i.e., six months after the date of death), should that value include proceeds from the sale of oil and gas produced since the date of death? In other words, do such proceeds represent a change in the form of assets of the gross estate, or do they constitute income?

Undisputed Facts

The facts are not in dispute. At the time of Nellie S. Johnston's death on January 27, 1974, she owned royalty and working interests in numerous oil and gas properties, principally in the state of Texas. Her executor elected to value the

gross estate on the alternate valuation date (six months after death), rather than at the date of death, as permitted by Section 2032 of the Internal Revenue Code of 1954, 26 U.S.C. §2032. During that six months, the sale of oil and gas generated net proceeds to the estate of $156,011, on which the executor duly paid income tax. The executor did not, however, include any part of these proceeds on the value of the gross estate.

Several years later the Internal Revenue Service assessed a deficiency against the estate, which was contested but paid, subject to this suit for refund. Part of the suit, a dispute over the valuation of certain assets in the estate, has been settled. The question remaining for decision is whether the decedent's gross estate also includes the six months of net production proceeds described above.

A determination of what the gross estate includes must begin with the definition of gross estate contained in 26 U.S.C. §2031:

> *§2031. Definition of gross estate*
>
> (a) General. — The value of the gross estate of the decedent shall be determined by including to the extent provided for in this part, the value at the time of his death of all property, real or personal, tangible or intangible, wherever situated.

An exception to §2031's rule for valuing all assets at the date of death is provided by §2032:

26 U.S.C. §2032. Alternate valuation

(a) General. — The value of the gross estate may be determined, if the executor so elects, by valuing all the property included in the gross estate as follows:

(1) In the case of property distributed, sold, exchanged, or otherwise disposed of, within 6 months after the decedent's death such property shall be valued as of the date of distribution, sale, exchange, or other disposition.

(2) In the case of property not distributed, sold, exchanged, or otherwise disposed of, within 6 months after the decedent's death such property shall be valued as of the date 6 months after the decedent's death.

* * *

The corresponding regulation interprets the statute as follows:

26 C.F.R. §20.2032-1. Alternate valuation.

(a) In general. In general, section 2032 provides for the valuation of a decedent's gross estate at a date other than the date of the decedent's death. More specifically, if an executor elects the alternate valuation method under section 2032, the property included in the decedent's gross estate on the date of his death is valued as of whichever of the following dates is applicable:

(1) Any property distributed, sold, exchanged, or otherwise disposed of within 6 months (1 year, if the decedent died on or before December 31, 1970) after the decedent's death is valued as of the date on which it is first distributed, sold, exchanged, or otherwise disposed of;

(2) Any property not distributed, sold, exchanged, or otherwise disposed of within 6 months (1 year, if the decedent died on or before December 31, 1970) after the decedent's death is valued as of the date 6 months (1 year, if the decedent died on or before December 31, 1970) after the date of the decedent's death.

* * *

Thus, the property to be included in Nellie S. Johnston's gross estate is that which she possessed on the date of death, although six months separate the two dates on which that same property may be valued.[1]

The nature of the (estate) tax is an excise tax on the transmission of th property from the decedent to his heirs, legatees or distributees. Clark v. U.S., 33 F.Supp. 216, 219 (D. Md. 1940). The estate tax therefore does not reach any property not owned (or previously transferred) by the decedent at the time of his death, and income subsequently arising from the taxable corpus of the gorss estate received by the decedent's beneficiaries is taxable to them as income. *Id.*

Piecemeal Sale Under Texas Law

Although the net production proceeds did not exist as part of Nellie Johnston's gross estate on the date of her death, the government contends that such proceeds are nevertheless part of her estate because production of oil and gas, which is a

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[1] The forerunner of Section 2032 did not require explanation by such a regulation as 26 C.F.R. §20.2032.1, for it unmistakably provided in the statute itself that

> "If the executor of an estate so elects upon his return . . . the value of the gross estate shall be determined by valuing *all the property included therein on the date of the decedent's death* as of the date one year after the decedent's death . . . " [emphasis added].

26 U.S.C. §811(j) (1935). *See* Maass v. Higgins, 312 U.S. 443, 444 n. 1 (1941).

wasting asset, reduces the whole of that property which belonged to the decedent at the date of her death, thereby converting what was formerly corpus into income. The government maintains that such a piecemeal sale of assets can give rise to both income tax and estate tax consequences.

In support of its theory that net production proceeds constitute a fractionalization and piecemeal sale of the decedent's interest in oil and gas in place at the time of her death, the government relies on the Texas law of oil and gas, although it acknowledges that state law is not always controlling in determining property interests for federal tax purposes. The government emphasizes authority such as Norris v. Vaughn, 260 S.W.2d 676, 679 (Tex. 1953), where the Texas Supreme Court decided that royalty paid for oil and gas produced from the separate property of a lessor belonged to his separate estate rather than to the community on grounds that extraction of minerals is "equivalent to a piecemeal sale of the separate corpus . . " and "that oil and gas producing territory will become exhausted in time."

More is involved in this case than a Texas community property question. This court must attempt "to give a uniform application to a nation-wide scheme of taxation" through legislation expressing the will of Congress. *See* Burnet v. Harmel, 287 U.S. 103, 110 (1932); Du Val's Estate v. Commissioner of Internal Revenue, 152 F.2d 103, 104 (9th Cir. 1945). In *Burnet*, the Supreme Court considered and rejected Texas law which regards an oil and gas lease as a present sale of the oil and gas in place.[2] It held that bonus and royalties paid to the lessor

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[2] The court also rejected the theory that federal authorization of a depletion allowance indicated the nature of the interest as an item of real property. *Burnet* at 111-12. In Anderson v. Helvering, 310 U.S. 404, 408 (1940) the Supreme Court buttressed this interpretation by describing the depletion allowance as "an act of grace" and an "arbitrary deduction."

constituted income to the lessor rather than a conversion of principal so that the amount received would not be eligible for taxation at the more favorable capital gains rate. As the court noted in *Burnet* at 110,

> State law may control only when the federal taxing act, by express language or necessary implication, makes its own operation dependent upon state law . . . [for] . . . the state law creates legal interests, but the federal statute determines when and how they shall be taxed.

Regardless of the characterization of interests in oil and gas properties under Texas law, sections 2031 and 2032 of the Internal Revenue Code do not state or imply that the levy of an estate tax on oil and gas interests is to be determined by reference to state law. The characterization of this property interest under Texas law is therefore not controlling.

Change in Form of Property

The government also presents weightier arguments, however, relying on a revenue ruling which extrapolates from language in 26 C.F.R. §20.2032-1(d) to the effect that property interests includible in the estate at date of death continue to be included in the estate at the alternate valuation date, even though such property has "changed in form during the alternate valuation date by being actually received, or disposed of, in whole or in part, by the estate." That regulation, in pertinent part, is set out in the margin.[3]

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[3] 26 C.F.R. §20.2032-1(d) reads, in pertinent part, as follows:

> *"Included property" and "excluded property".* If the executor elects the alternate valuation method under section 2432 [sic], all property interests existing at the date of decedent's death which form a part of his gross estate as determined under sections 2033 through 2044 are valued in accordance with the provisions of this section. Such property interests are referred to

The government argues for the proposition that most of the income received in the interim period is not income at all, but represents principal which has merely changed in form, depleting the asset in existence at the date of death.[4] As authority, the government cites Revenue Ruling 71-317, 1971-2 C.B. 328. Purporting to clarify Revenue Ruling 66-348, 1966-2 C.B. 433, Revenue Ruling 71-317 provides that where royalty and working interests are concerned, the "in place"[5] fair market value of the reserves (units of mineral remaining) must be determined as of the alternate valuation date. Without explaining why the net proceeds must be included in the value of the gross estate, Rev. Rul. 71-317 prescribes the method to be used for computing the apportionment.[6] The net production proceeds, lessened

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in this section as "included property". Furthermore, *such property interests remain "included property"* for the purpose of valuing the gross estate under the alternate valuation method *even though they change in form* during the alternate valuation period by being actually received, or disposed of, in whole or in part, by the estate. On the other hand, property earned or accrued (whether received or not) after the date of the decedent's death and during the alternate valuation period with respect to any property interest existing at the date of the decedent's death, which does not represent a form of "included property" itself or the receipt of "included property" is excluded in valuing the gross estate under the alternate valuation method. Such property is referred to in this section as "excluded property" . . . [emphasis added].

[4] The government apparently takes the position that the net production proceeds are income for purposes of the income tax already paid but principal for purposes of the estate tax.

[5] "In place" is defined as minerals in their natural state, that is, in the earth prior to extraction.

[6] "The value of the included property is determined by applying an appropriate discount factor to the net proceeds (net income) from mineral production during the interim period. Such determined value is added to the fair market value of the reserves (units of mineral remaining) as of [the alternate valuation date]. The

only by an "appropriate" discount factor,[7] must be added to the fair market value of the units of mineral remaining as of the alternate valuation date, and are thus included in the gross estate.

A comparison of Rev. Rul. 71-317 with Rev. Rul. 66-348, reveals that Rev. Rul. 71-317, far from merely clarifying the methodology of the earlier ruling, actually represents a marked change in substantive approach. Rev. Rul. 66-348 prescribed an altogether different method for establishing the amount of income to be included in the gross estate. That computation was to be made by valuing 100 percent of the units of mineral extracted and sold during the interim period at their "in place" value[8] *as of the date of disposition*, and including the full amount thereof in the gross estate. Rev. Rul. 71-317, by contrast, discounts by an "appropriate" factor the net proceeds during the entire interim period and adds that figure to the value of the gross estate as of the alternate valuation date. Although the position of the Internal Revenue Service clearly changed between 1966 and 1971, the court has found no case

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discount factor used will vary from case to case but will be determined by taking into account the particular facts of each case, such as producing rate, type of interest owned and economic factors such as interest rates." Rev. Rul. 71-317 in pertinent part.

[7] The example in the revenue ruling uses 12%.

According to the government, such a discount represents a reasonable return on the investment over the six-month period, adding that "The amount of discount from net proceeds under R.R. 71-317 . . . would be slight." Government's brief in support of summary judgment at 18. It is undisputed that the inspector ignored the discount formula when he calculated the amount of the deficiency, although the government now concedes that it should be taken into account.

[8] Plaintiffs describe the "in place" value of oil or gas as "usually about ⅓ of the amount for which it is sold at the surface", citing 21 Oil and Gas Tax Quarterly, 14 at 20 (1972).

authority supporting either of its interpretations of the statute (26 U.S.C. §2032) as set forth in these revenue rulings.

Significantly, the methodology of Rev. Rul. 71-317 appears to conflict with §2032(a)(1), which deals with property distributed, sold, exchanged, or otherwise disposed of, within 6 months after the decedent's death. The statute requires that such property "shall be valued as of the date of distribution, sale, exchange, or other disposition," not at the alternate valuation date. It is undisputed that the net production proceeds in issue here resulted from the sale of minerals by the Johnston estate, yet the government would establish the value of these minerals by reference to a date different from that prescribed by the statute.

What the later revenue ruling has in common with the earlier one is the premise, without accompanying analysis, that "The extraction and sale of minerals from a mineral interest, which formed a part of the decedent's gross estate, during the alternate valuation period is merely a change in the form of 'included property'. It is clear that no portion of the physical assets sold is 'excluded property'." Rev. Rul. 66-348.[9]

Both the taxpayer and the government agree on those cases which the court must consider in determining the issue before it, but each adversary views those cases in a different light. The reasoning underlying those cases necessarily illumines the path which this court must follow, since neither the statute itself, Sec. 2032, nor the accompanying regulation, 26 C.F.R. §20.2032-1(d) deal specifically with income from mineral inter-

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[9] As noted earlier, the concept of changing form derives from 26 C.F.R. §20.2032-1(d), which fails altogether to mention mineral interests.

ests.[10] In two cases decided within a year of each other, courts presented with the issue held invalid Art. 11 of Regulations 80 (1937 Ed.), which interpreted §302(j) of the Revenue Act of 1926, as amended by §202(a) of the Revenue Act of 1935 (a predecessor of present section 2032).

In the leading case of Maass v. Higgins, 312 U.S. 443 (1941), the court described the regulation as requiring "that if, during the year subsequent to death, rents, *royalties*, interest or dividends were received by the decedent's estate, such portion thereof as had not accrued, or was not attributable to a period prior to death, should be returned in full and reckoned as part of the gross estate in any case where the executor elected . . . to value the assets as of [the alternate valuation date][11] or as of the date of disposition . . . " (emphasis added). *Maass* at 446. Since the facts of that case dealt only with rents, dividends and interest, the court's opinion did not reach the subject of royalties.

In the lower courts the government had presented an argument similar to its "wasting asset" argument in this case, contending that the disputed items were in truth payments on account of principal and that by such payments the principal was reduced so that at the end of the period, its true value was not reflected unless the payments received in the interim were added to the valuation determined at the end of the period.

The court held, however, that rent, dividends and interest were not to be added, noting that in common understanding such items were income upon which executors were bound,

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[10] Subsections of the regulation do deal, however, with interest, rents, bonds and certain corporate stock. *See* 26 C.F.R. §20.2031-1(d) (1-4). These items are not includible in the gross estate.

[11] At that time the applicable statute designated the date one year from date of death as the alternate valuation date.

under the revenue acts, to pay tax as income.[12] In the case of a living holder, such receipts are never treated as on account of principal. *Maass* at 447.

The court concluded that whichever date is selected by the executor, the usual method of valuation should be pursued:[13]

> If Congress intended the result for which the Government contends, namely, that a different method should apply at the end of the [alternate valuation] period than that applicable as of the date of death, it would have been a simple matter so to state.

Maass at 448-49.

Because the uniform practice was to value the asset as an entirety,[14] the court found the government's argument that the asset consisted of two elements unreal and artificial. That which had not been legally separated from the asset of which it was an incident had no market value apart from the capital asset itself. *Id.*

While the Supreme Court did not allude to the carefully reasoned opinion issued the previous year in Clark v. United States, 33 F.Supp. 216 (D. Md. 1940), which invalidated the identical regulation as to stocks and bonds, *Maass* supports the statement in *Clark* at 221 that

> [T]he view advanced by the regulation ignores the real nature of income, which is something arising and *severed*

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[12] This conclusion accords with the holding in *Burnet, supra,* that bonus and royalties constituted income to the lessor, not a conversion of principal, so that the favorable capital gains rate did not apply.

[13] The property to be valued at the alternate date is the same property required to be included in the gross estate at date of death. 26 C.F.R. §20.2032-1(a). *See also Clark,* below, at 219.

[14] *See also* Burnet v. Harmel, 387 U.S. 103, 111 (1932).

> *from* the principal, and not a growth or an increment of value in the principal [emphasis in original].

See also Eisner v. Macomber, 252 U.S. 189, 206-7 (1920).

The concept of separation became the touchstone for later decisions which, in each instance, analyzed whether proceeds during the interim period constituted principal or income by determining whether they had been severed from the asset or added to the asset.[15]

In Estate of Schlosser, 277 F.2d 268 (3rd Cir. 1960), the court held that a true stock dividend *was* includible in the executor's valuation at the end of the alternate period because there had been "no step toward the severance or distribution of part of the corporate estate." *Schlosser* at 269. Rather than a severance of earnings and profits, the true stock dividend had merely changed the form of the estate's investment by increasing the number of its shares.[16] *Id.*

Relying heavily on the reasoning of *Maass* and *Schlosser*, the court in Bartram v. U.S., 75-1 USTC, Fed. Estate & Gift Tax Rep. (CCH) ¶ 87,375 (D. Conn. 1974), decided that a capital gains dividend declared on mutual fund shares during the interim period was not includible in the gross estate. The *Bartram* court acknowledged that the value of a mutual fund

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[15] In no case cited to this court has it ever been decided that payments such as those at issue here constituted *both* principal and income, as the government apparently contends in this case. Moreover, "while the Constitution does not forbid double taxation, the intent to impose it on a given receipt is not presumed. We think that if it had been intended, Congress unequivocally would have so declared." *Maass* at 448-49. See also *Clark* at 223 (not reasonable to interpret statute as imposing double taxation, unless required by express words).

[16] The concept of changing form appears also in 26 C.F.R. §20.2032-1(d), as described, *supra*.

share is equal to a *pro rata* share of the fund's net assets, so that the payment of a capital gains dividend reduces the value of the shares then outstanding. Nevertheless, because there had been a transfer of value from the estate, the *Bartram* court found the result logical, stating that under the *Maass* rule, payment of income accrued after death may effectively reduce the estate without incurring estate tax liability. *Bartram* at 87,377.

When the *Maass* rule is applied to the mineral interests involved here, it is apparent that the royalties and production payments which accrued to the Johnston estate during the interim period did not divide the estate's existing ownership into a greater number of smaller units as did the stock dividend in *Schlosser*. *Cf. Schlosser* at 269. On the contrary, the minerals and the monetary proceeds were severed from the estate, thereby diminishing the number of units which had been in the estate at the date of death.

The parties disagree about whether this diminution had the effect of decreasing the value of the gross estate at the alternate valuation date as compared to the value at the date of death. The executor contends that market forces caused the value of the property to increase in that interim, while the government argues that, based on the smaller amount of reserves remaining, the property must have had a lower value. This question need not, however, be decided.

Even if it were true that the value of the estate had diminished during the interim period, the benefit to the estate would harmonize with the purpose of Congress in providing for an alternate valuation date. As the Supreme Court declared in *Maass* at 446,

> [T]he purpose of (the predecessor to Sec. 2032) was to mitigate the hardship consequent upon shrinkage in the value of estates during the year following death.

See also *Clark* at 222 (the legislation represented efforts to ameliorate the burden of estate taxation). To require that such interim depletion be added to the value of the asset as established on the alternate valuation date pursuant to Rev. Rul. 71-317 might well defeat the ameliorative purpose of the statute.

This result also accords with the Supreme Court's opinion that "the production of oil and gas ... is treated as an income-producing operation, not as a conversion of capital investment as upon a sale, and is said to resemble a manufacturing business carried on by the use of the soil." Anderson v. Helvering, 310 U.S. 404, 407-08 (1940). *See also Burnet* at 107 (rejecting argument that net result of a mining operation is a conversion of a capital investment, so that money received is capital in a changed form).

In summary, it is the conclusion of this court that proceeds from the extraction and sale of minerals during the interim valuation period do not represent a mere "change in form." As a result, like interest and rents, they are not includible in the gross estate as valued six months from date of death. *See* Bull v. U.S., 295 U.S. 247, 256 (1935) ("Had he lived, his share of profits would have been income . . . and if the right was not capital to him, it could not be such to his estate"). Not only is Rev. Rul. 71-317 inconsistent with the meaning of the statute, Section 2032, but in many instances the required computation would increase the burden on the taxpayer, preventing executors of estates containing mineral interests from availing the estate of an election valuable to owners of stocks, bonds and rental property.

For the foregoing reasons, the court holds that proceeds derived from oil and gas properties during the six-month period prior to the alternate valuation date constitute income, not principal. The executor shall recover the refund he claims for the Johnston estate, as well as the interest thereon. Accord-

ingly, plaintiff's motion for summary judgment is **GRANTED** and defendant's motion for summary judgment is **DENIED**. Within twenty days of the date of this order, the parties shall agree upon the correct computation of the sum in question and submit a proposed form of judgment.

April 27, 1984.

/s/ A. JOE FISH

A. JOE FISH

United States District Judge

CERTIFICATE
OF
SERVICE

CERTIFICATE OF SERVICE

I hereby certify that on this 4th day of April, 1986, three copies of the Petition for Writ of Certiorari were mailed, postage prepaid, to (i) Solicitor General, Department of Justice, Washington D.C. 20530 and (ii) Glen L. Archer, Jr., Esq., Assistant Attorney General, Tax Division, Department of Justice, Washington, D.C. 20530, Attention: Michael L. Paup.

F. Franklin Honea

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